



August 26, 2011

## HIGHLIGHTS

- TD Economics is expecting the release of next week's national accounts data to reveal that the Canadian economy stalled in the second quarter of 2011, with a significant risk of a slight contraction.
- While the headline number is expected to be disappointing, the details of the report are expected to paint a more upbeat picture of the Canadian economy.
- Temporary factors, such as supply disruptions from the Japanese earthquake and a number of shutdowns in the energy sector likely weighed on economic activity in the quarter. Meanwhile, a significant drag from net trade likely masked a number of domestic strengths.
- Our base case forecast for the Canadian economy calls for a modest pick-up in economic growth over the second half of this year. We anticipate average quarterly economic growth of about 1.5% on average over the next two quarters.

David Tulk,  
Chief Canada Macro Strategist,  
416-983-0445  
[david.tulk@td.com](mailto:david.tulk@td.com)

Diana Petramala  
Economist (Canada)  
416-982-6420  
[diana.petramala@td.com](mailto:diana.petramala@td.com)

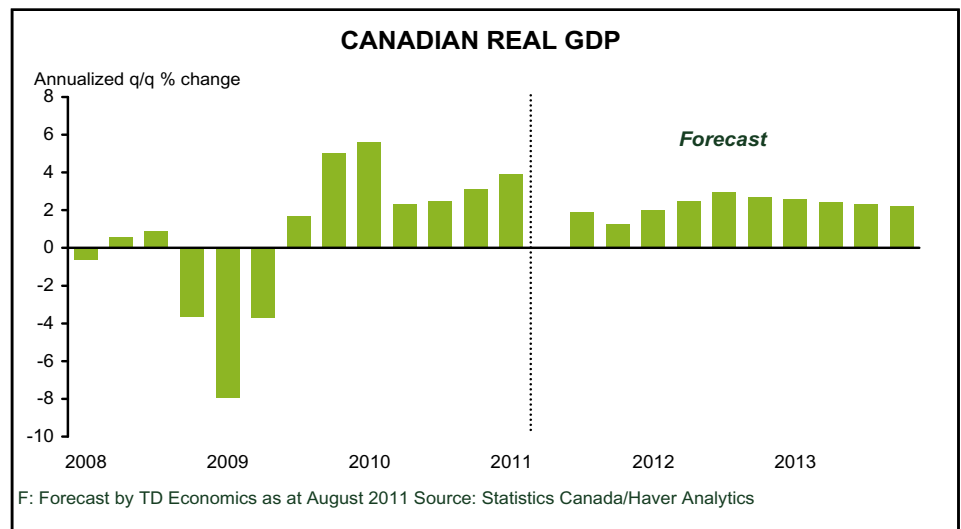
## A LOOK AHEAD TO NEXT WEEK'S CANADIAN REAL GDP RELEASE

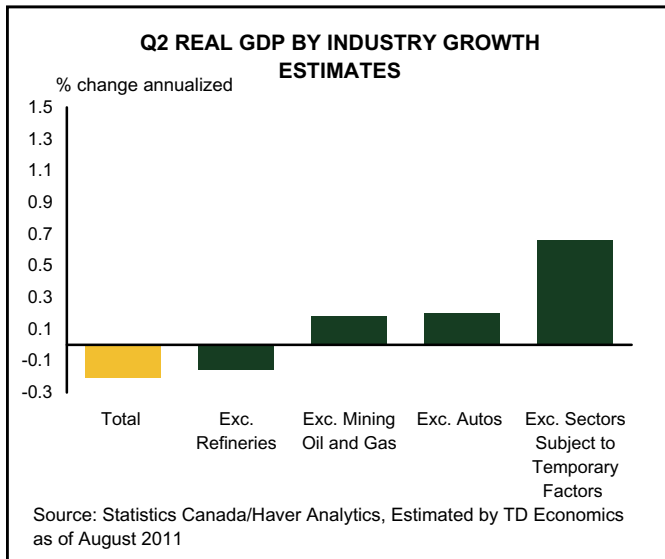
TD Economics is expecting the release of next week's national accounts data to reveal that the Canadian economy stalled in the second quarter of 2011. However, a significant drag from net trade in the quarter raises the possibility of a contraction in real GDP. While the headline number will signal some weakness, the details of the report are expected to be more upbeat as it masked domestic strengths. Moreover, forward looking indicators suggest a modest pick-up in economic growth over the second half of 2011.

### Q2 tracking is weak

So, what do we know from the data released over the April-June period so far? Statistics Canada releases a monthly estimate of GDP by industry, which over time lines up with the more commonly watched quarterly national accounts data. Real GDP by industry was flat in April and fell by 0.3% in May. And, TD Economics estimates that it stalled in June. When you put it all together, the monthly GDP by industry data is pointing to a mild contraction of -0.2% annualized in the second quarter. Essentially, this can be interpreted as no growth. While much of Canada's economic woes over the second quarter largely reflect weak U.S. demand and a lofty Canadian dollar, some of the softness was also due to temporary factors. The Canadian auto sector was particularly hard hit by supply disruptions in the wake of the Japanese earthquake. Meanwhile, the energy sector experienced a number of short-lived shutdowns in the wake of bad weather and fires in Alberta. In addition, a number of refineries shut down in May for retooling. Once you exclude automotive and energy production, real GDP by industry likely rose modestly in the quarter.

Turning to the quarterly accounts data, TD economics estimates that growth was close to 0% in the second quarter. Given the temporary factors mentioned above, exports are estimated to have fallen by an annualized 10% in the April-June period. Government spending was also likely a weak spot for the Canadian economy in light of the expiration of a number of government fiscal stimulus spending programs.





On the flip side, most other major components of domestic demand are expected to contribute strongly to growth in the quarter, posting a combined gain of 3.2%. Retail sales point to a 2.5% advance in consumer spending. Residential investment is estimated to have increased 6.0%, as housing starts climbed a sharp 12% over the April-June period. Lastly, strong imports of machinery and equipment suggest that business capital spending contributed strongly to growth. Unfortunately, much of the strength in overall domestic demand was likely serviced through imports, which are projected to have increased 10%. Inventories are a wild card. Monthly manufacturing and wholesale inventories imply that an inventory rebuild helped bolster growth in the second quarter – but the degree of the rebuild is subject to considerable uncertainty. All told, a significant drag from net trade is expected to completely offset domestic strengths, leading to our flat tracking for the quarter.

**One quarter of contraction need not make a recession**

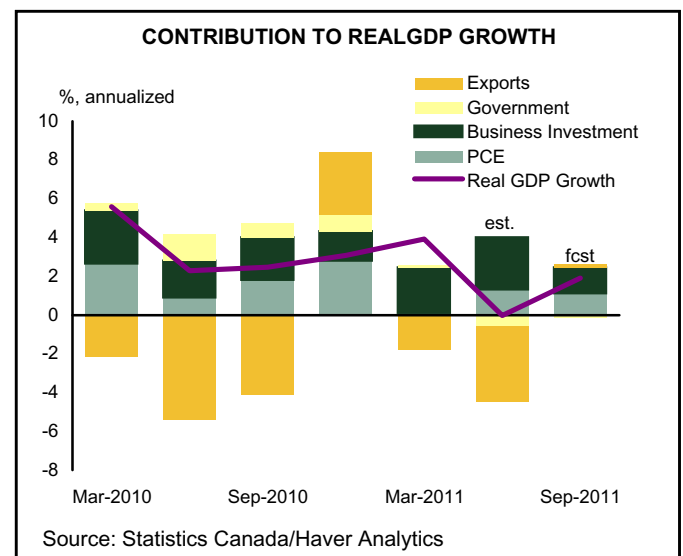
Given our tracking for a flat recording on real GDP, one cannot rule out the possibility that the actual outcome could be a small contraction. However, any decline in real GDP is easier to swallow when you consider that it is coming on the heels of a strong 3.9% annualized gain in the first quarter of the year. In other words, even if there was a small dip, Canadian real GDP would still have increased by an average of 2.0-2.5% annualized over the first half of 2011 – triple the growth rate experienced in the United States. Regardless, any figure in negative territory would likely generate heightened attention to the risks of a renewed recession.

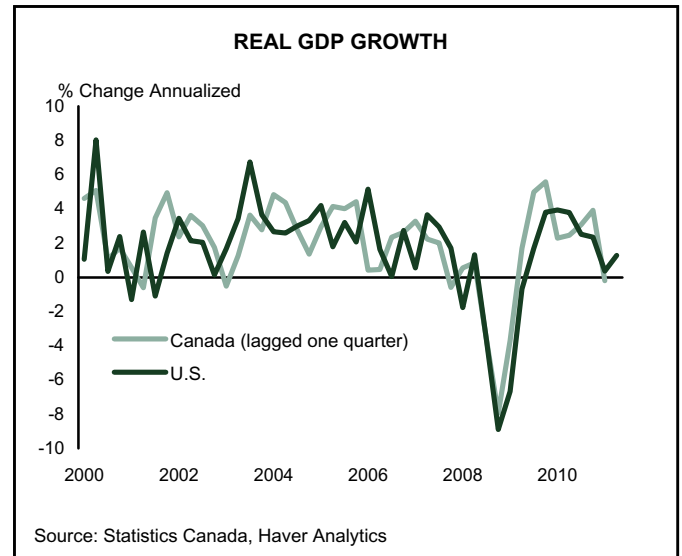
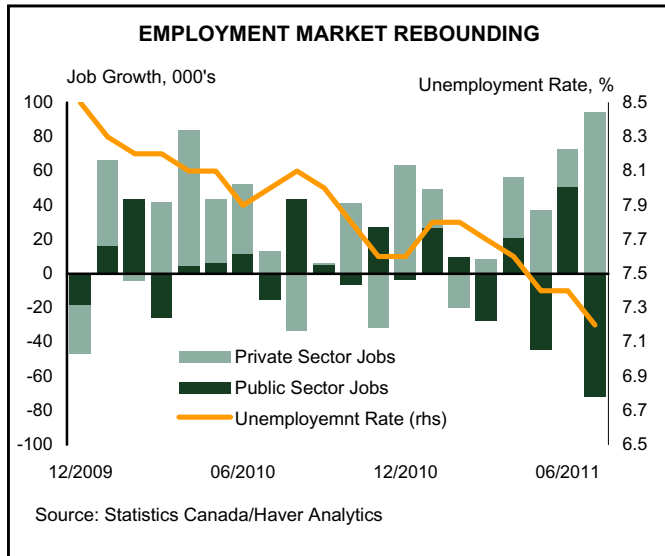
TD Economics feels that the odds of a second consecutive quarterly decline in the third quarter – the technical

definition of a recession – are low. Economic indicators released thus far indicate that growth should accelerate mildly in the next quarter to a modest pace of 1.9%. For one, temporary factors are expected to fade over the coming months. In particular, U.S. auto production appears to be bouncing back from the supply disruptions. Second, after growing by an average 0.8% over the first half of 2011, U.S. real GDP growth is projected to pick-up to 1.5% in the third quarter of this year. Third, some of the momentum in Canadian domestic demand carried forward into July with housing starts climbing to 205,000 units, and there was a continued improvement in the labour market. Meanwhile, existing home sales were flat in the month, yet remain at robust levels. Finally, Canada’s financial system is robust, and credit is continuing to flow to businesses and households.

That being said, the risks of a renewed downturn occurring in the fourth quarter of this year and at the start of 2012 are high. TD Economics has come out publicly with a 40% probability of a renewed recession over the next year. Since roughly one-third of Canadian exports, and 70% of exports are U.S. bound, any dip into recession in the U.S. would bring Canada along for the ride. Much will depend a great deal on the impact the recent financial turmoil will have on business and consumer confidence. The evolution of political uncertainty in Europe and the U.S. is also key, of which the financial consequences will likely be felt through the fall months. However, should a recession occur, the contraction would be dramatically milder than the 2008-2009 experience.

Indeed, concerns over a European sovereign debt crisis, and recent market turbulence is expected to weigh on Canadian and U.S. consumer and business sentiment and balance





sheets over the second half of 2011. As such, we do expect a noticeable deceleration in spending and investment over the next six months. Nonetheless, our base case economic forecast calls for continued growth over the second half of the year.

**Bottom line**

The Q2 data are expected to confirm that amid a global economic slowdown, the Canadian economy has followed suit. Indeed, it is a coin toss on whether the Canadian economy stalled or contracted in the quarter. At the same time, however, the details of the report almost certainly will

paint a more upbeat picture of the Canadian economy. For one, the contraction was not broad based across industries, or spending components. Second, the weakness was largely due to temporary factors weighing heavily on the Canadian export sector, rather than concentrated across domestic sectors. Third, while the risks of a renewed U.S. and Canadian recession have increased significantly, it is not our base case forecast. Overall, we look to a modest pick-up in economic growth over the second half of this year. That being said, the risks of a renewed recession are greatest for the end of this year.

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